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As I see

INFLATION CLAUSES IN REAL ESTATE INSTRUMENTS

THE war in Korea will undoubtedly feed a new inflationary spiral. The value of money is certain to decline as a result of the actual war and of the government deficits which will accompany and follow it. This is causing many investors to look for inflation hedges in all types of written instruments involving long-term commitments.

There have been relatively few long periods in the world's history when the value of money remained relatively stable. Each period in which the value of money declined rapidly has brought numerous efforts to protect the purchasing power of the principal involved. Older business men and investors are all familiar with the gold clause which appeared in practically all mortgages and other instruments written prior to 1933, when the United States canceled the gold clauses in all contracts, both public and private. This clause was generally worded that the obligation was payable in gold coin of the present standard of weight and fineness. Even this clause, when it was operating, was not sufficient to protect the lender against loss which came about through a changing value of the dollar, regardless of its gold content. For instance, if in 1918 the purchasing power of the dollar was considered as 100¢, by 1920, just two years later, it had declined to 75¢, in spite of the fact that the dollar was freely convertible into gold during the entire period and no change had been made in the rate of conversion.

Various attempts have been made in the past to provide that the payment of a debt should be measured by the amount necessary to buy a standard list of articles. In 1576, a statute was enacted in England, providing that *"in all College Leases to be thereafter made, at least one third part of the old rent should be reserved in Wheat and Malt, after the rate of 6s. 8d. per Quarter for Wheat, and 5s. per Quarter for Malt; and such rents, unless delivered in kind, were to be paid after the rate at which the wheat and malt should be sold the next market day before the rent fell due."*[1] This particular law was an attempt to protect the recipients of fixed incomes from the effects of the inflow of silver and gold from the New World.

In 1778, during the Revolutionary War, a law was passed by the State of Massachusetts attempting to adjust for the depreciating currency in payments to soldiers from that State. These men were paid in notes. The amount of cash which each was to receive when the notes were paid was to vary in accordance with the pur-

[1] Tooke and Newmarch. History of Prices, Vol. 6, p. 354.

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chasing power of money at that time. A quotation from one of these notes follows:

> *Both Principal and Interest to be paid in the then current money of said State, in a greater or less Sum, according as Five Bushels of CORN, Sixty-eight Pounds and four-sevenths Parts of a Pound of BEEF, Ten Pounds of SHEEP'S WOOL, and Sixteen Pounds of SOLE LEATHER shall then cost, more or less than One Hundred and Thirty Pounds current Money, at the then current Prices of said Articles.—This Sum being Thirty-two Times and an Half what the same Quantities of the same Articles would cost at Prices affixed to them in a Law of this State made in the Year of our Lord One Thousand Seven Hundred and Seventy-seven—.*[2]

When the United States cut the convertibility of its money to gold in 1933, lending money became a hazardous venture, with the possibility that regardless of the nominal rate of interest which the loan carried, the actual rate of interest might be a negative one and in the end the lender would pay the borrower to use his money. It is very easy to illustrate how this is true. Suppose, for example, that in 1933 an individual purchased a $1,000 bond which paid 2½% interest. If the bond were purchased at par and is still quoted at par, the investment would have worked out as follows. In the last 17 years this individual would have collected $425 in interest. If he sold the bond at par today, he would get back the original $1,000, and the principal and interest from his investment would amount to $1,425. However, if the amount of goods and services which he could have bought in 1933 is compared with the amount that he would buy today, it will be discovered that the $1,425 will purchase only 77% as much as the $1,000 would have purchased then. In other words, if the loss of $230 of purchasing power is distributed over the 17 years, it will be found that the individual lending the money paid the borrower 1.35% per year to use his money.

Long before the advent of the Second World War our organization was recommending the inclusion of certain inflation hedges in various types of instruments, including subdivision restrictions. One such subdivision restriction written by this organization in August 1937 contained the provision that "no residence shall be erected, the contract price of which is not more than 115 times the index of wholesale building material prices as published monthly by the United States Bureau of Labor Statistics." At the time that this restriction was written, the minimum price under this formula for the construction of a house was $11,070; today, the minimum price is $24,640. This has resulted in the same general quality of home being built in this development today as the ones built in 1937 and 1938 before the Second World War started. It is only necessary to compare the restrictions of this subdivision with those of the one adjoining it, laid out somewhat earlier. The earlier subdivision, which was largely built up during the twenties and thirties, had a fixed provision that the contract cost of the house must be at least $7,500. All of the earlier buildings in this area would be of the type which would sell on today's market for from $20,000 to $35,000 or $40,000. About 15% of the lots are still unused and, of course, the restrictions are valueless.

Since 1937, when the restrictions referred to above were drawn, a great deal

[2] Fisher, W. C. The Tabular Standard in Massachusetts History, Quarterly Journal of Economics, Vol. XXVII, p. 437, May 1913.

of time and effort has been devoted to working out the best types of inflation hedges. We believe that for mortgages and leases the best hedge is to tie the dollar consideration to the Consumers' Price Index, published by the United States Bureau of Labor Statistics. This index was formerly known as the Cost of Living Index, and it has been published continuously since 1913. It is available for 34 major cities of the United States, but our recommendation would be that the national averages be used rather than the city figures. It attempts to measure the cost of goods and services each month purchased by a wage-earning family. I think that it represents more nearly than any other index the actual purchasing power of the dollar for the average individual.

There are a number of advantages to this particular index. These advantages could be listed as follows:

1. It has been very carefully compiled by trained statisticians at a cost far greater than any one organization would be justified in spending to determine the facts.

2. Since this index is used in many union contracts as a basis for automatic adjustments, it is under constant scrutiny from both labor statisticians and the statisticians of big industrial concerns like General Motors, to be sure that it does not contain bias. A number of years ago a complaint was raised against the index and a special committee of outstanding members of the American Statistical Association was appointed to make a thorough study of the index and to recommend any changes which they thought should be made. This committee published their findings in an exhaustive report which made only minor recommendations for changes and which otherwise sustained the index as it had been compiled.

3. The index is readily available as it appears each month in the "Monthly Labor Review," published by the Bureau of Labor Statistics and available to any subscriber for $4.50 a year. It is also in the reference department of practically every public library in the United States.

4. The chance of the index's being discontinued is negligible, as it has been widely used by so many different groups of labor, industry and government.

A suggested outline for an inflation clause in a lease or similar document might run somewhat as follows:

". . . at an annual rental in dollars equivalent to the present purchasing power of $5,000. The purchasing power of this amount is to be determined in subsequent years by the following method. For the first year of the lease the rental will be considered to be the base amount of $5,000. The rental for each subsequent year shall be determined by dividing the base rent of $5,000 by the index number for the Consumers' Price Index for moderate-income families for large cities combined, published monthly in the "Monthly Labor Review" of the Bureau of Labor Statistics of the United States Department of Labor, for the month in which this lease becomes effective and then multiplying that amount by the index number for the second month preceding the beginning of each subsequent year.

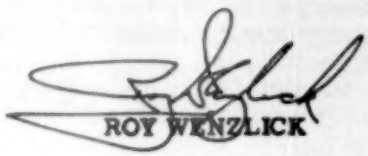
"In the event that the Bureau of Labor Statistics should change the base period

(now 1935-1939 = 100) the new index number for the month in which the lease became effective shall be substituted for the index number originally used as the divisor for the rental specified in the first year of the lease.

"In the event that the Consumers' Price Index of the United States Bureau of Labor Statistics is discontinued, the lessor and the lessee mutually agree to select as nearly comparable statistics on the purchasing power of the consumer dollar as are then available published in some responsible financial periodical of recognized authority."

For example, suppose a lease for 25 years became effective on June 1, 1950, at a rental equivalent to the purchasing power of $5,000 at that time. The rental for the first year according to the terms of this lease would be $5,000 even. The rental for the second year would be determined as follows. The Bureau of Labor Statistics Consumers' Price Index for June in the "Monthly Labor Review" is given as 170.2. Five thousand dollars is, therefore, divided by 170.2, with a result of $29.38. If the index for April 1951 should be, for example, 180, the rental for the year starting June 1951 would be $29.38 x 180, or $5,288.40. Each succeeding year is to be figured in like fashion, in each case using the published index number for the second month preceding. The base factor for all subsequent years will remain in this lease at $29.38, unless the base period of the series is changed by the United States Bureau of Labor Statistics.

We believe that a wording somewhat similar to the above constitutes the best inflation provision available at the present time. Being an economist and statistician rather than a lawyer, I have made no effort to put in the necessary "to-wit's" and "whereas's," as I considered the explanation sufficiently complicated in plain English. Your own attorney can adapt this fundamental idea to the various types of instruments in which it would be suitable.



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